

Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200816030**

Release Date: 4/18/2008

CC:TEGE:EOEG:ET1:
FILEN-105420-08

UILC: 1402.01-00, 1402.01-01

date: March 18, 2008

to: Mary Gorman
Asst. Division Counsel (Prefiling)
(Small Business/Self-Employed)

from: Janine Cook
Branch Chief, Employment Tax Branch 1 (Exempt Organizations/Employment
Tax/Government Entities)
(Tax Exempt & Government Entities)

subject: Qualified Joint Ventures and Rental Business Income

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Does a husband and wife's election of qualified joint venture status ("QJV") pursuant to I.R.C. section 761(f) for a rental real estate business convert the income derived from the business into net earnings from self-employment ("NESE") when the income otherwise would be excluded from NESE under section 1402(a)?

CONCLUSION

No, if the income is otherwise excludable from NESE under section 1402(a), election of QJV status does not convert such income into NESE.

BACKGROUND

On May 25, 2007, the Small Business and Work Opportunity Tax Act of 2007 ("Act"), P.L. 110-28, amended the Internal Revenue Code ("Code") to add section 761(f) to the Code. Section 761(f) provides special rules for a "qualified joint venture" ("QJV"), effective for taxable years beginning after December 31, 2006. Section 761(f) provides

that a qualified joint venture shall not be treated as a partnership for federal tax purposes. Thus a husband and wife who elect QJV status do not need to file a partnership income tax return. Rather, they are treated as maintaining two sole proprietorships for all federal tax purposes, including income tax and self-employment tax, and are required to file tax returns accordingly.

The IRS has communicated to taxpayers that when a husband and wife elect QJV status, each spouse must file with their joint income tax return a separate Schedule C (Form 1040), *Profit or Loss From Business (Sole Proprietorship)* or Schedule F (Form 1040), *Profit or Loss From Farming*, and a separate Schedule SE (Form 1040), *Self-Employment Tax*, as applicable. See the article on the IRS website at www.irs.gov, keyword “qualified joint venture.” While the general instructions for the 2007 Form 1040 do not address the reporting of rental real estate income that would otherwise be reported on Schedule E (Form 1040), *Supplemental Income and Loss*, for those making a QJV election, the instructions for the 2007 Schedule E have informed taxpayers who make the QJV election for a rental real estate business that each spouse must report his or her share of such income on their respective Schedules C and not on Schedules E.

We understand that various IRS and Counsel offices have received questions asking whether the QJV election results in the imposition of self-employment tax on income from a rental real estate business that would otherwise not be subject to self-employment tax.

LAW AND ANALYSIS

The Act added section 761(f) to the Code which provides that a QJV shall not be treated as a partnership for federal tax purposes. A QJV is a joint venture that conducts a trade or business¹ where: (1) the only members of the joint venture are a husband and wife who file a joint return, (2) both spouses materially participate in the trade or business, and (3) both spouses elect not to be treated as a partnership. I.R.C. section 761(f)(2). For this purpose, “material participation” has the same meaning as under the passive activity loss rules in section 469(h) and the corresponding regulations. *Id.*² The spouses must divide the items of income, gain, loss, deduction, and credit in accordance with their respective interests in the venture, and each spouse takes into account each item as if it were attributable to him or her as a sole proprietor. I.R.C. section 761(f)(1)(B) and (C).

¹ Note that a husband and wife must be conducting a trade or business; mere joint ownership of property does not qualify for the election.

² Note that, except as provided in section 469(c)(7), rental real estate income or loss generally is treated as passive income or loss under section 469. The presence of “material participation” does not change the passive character. Accordingly, the spouses’ QJV election, premised on the spouses’ material participation, does not alter the character of passive income or loss.

Generally, the Code imposes a tax upon an individual's self-employment income, defined as net earnings from self-employment ("NESE") with certain adjustments. I.R.C. sections 1401 and 1402(b). The Code defines NESE generally as gross income derived by an individual from a trade or business, plus the distributive share of income or loss from a partnership of which the individual is a member. The Code enumerates many exceptions to this general definition. I.R.C. section 1402(a). One such exception excludes rental income from real estate from the definition of NESE, unless such rental income is received in the course of a trade or business as a real estate dealer.³ I.R.C. section 1402(a)(1). Other provisions generally exclude dividend income and gain or loss from sale or exchange of a capital asset. See I.R.C. sections 1402(a)(2) and (3).

The Act further amended the definition of NESE by adding new section 1402(a)(17). New section 1402(a)(17) states:

"[N]otwithstanding the preceding provisions of this subsection, each spouse's share of income or loss from a [QJV] shall be taken into account as provided in section 761(f) in determining [NESE] of such spouse."

The relevant legislative history makes clear that NESE is determined by taking into account each spouse's respective share of the business from the QJV, just as for federal income tax purposes. See H.R. Rep. No. 110-14, at 14–16 (2007) ("Report"). The Report indicates that the reason for the change is to reduce complexity for business ventures run by a husband and wife filing a joint return by eliminating the need to file a partnership income tax return because the "reported income would be the same on a joint return, whether or not a partnership return is filed." *Id.* at 15. The Report also expresses Congress' concern that, in some cases, only one spouse reports the net earnings from self-employment from the venture, with the result that only one spouse receives credit for social security benefit purposes. *Id.* at 15.

Congress intended each spouse to account for his or her respective share of the QJV income as a sole proprietor, "anticipat[ing] that each spouse would account for his or her respective share on the appropriate form, such as a Schedule C." *Id.* at 16. Additionally, in explaining its reasons for the change, Congress expressed its expectation that "both spouses, not just one, should be treated as having net earnings from self-employment from the venture in accordance with their respective interests." *Id.* at 15. Taken together, the legislative history suggests that any income earned by a QJV is reported for all federal tax purposes using the same forms as if each spouse were a sole proprietor who earns such income.

³ However, income from renting farm property is included in NESE and is subject to SECA tax if the income is derived by a contract between the owner or tenant of the land and another individual to produce agricultural or horticultural commodities, such contract provides that the owner or tenant of the land will materially participate in the production of the commodity, and such person does so materially participate. See I.R.C. section 1402(a)(1).

Generally, an individual who has income from a rental real estate business would not be subject to self-employment tax on such income because it is excluded from NESE. I.R.C. section 1402(a)(1). The individual would report such income on a Schedule E (Form 1040). Amounts on the Schedule E are carried over to the individual's appropriate income tax return (usually a Form 1040, *U.S. Individual Income Tax Return*), but are not included on Schedule SE (Form 1040) in calculating self-employment tax.

The specific language of section 1402(a)(17) provides that each spouse's share of the QJV income shall be taken into account in determining the NESE of each spouse. The reference back to section 761(f) prescribes how the total income of the QJV is to be divided between the spouses. The phrase "notwithstanding the preceding provisions of this subsection," read in context with the rest of section 1402 and the legislative history discussed above, directs that none of the preceding subsections is to alter that allocation between spouses. To read the phrase "notwithstanding the preceding provisions of this subsection" as nullifying the application of all the exclusions from NESE would trigger dramatic changes in the application of self-employment tax to spouses electing QJV. Not only rental real estate income from a QJV, but also dividends and capital gains, would become subject to self-employment tax if earned by a QJV. We find no indication in the statute or legislative history that Congress intended the "notwithstanding" phrase to be read in that way. The purpose of section 761(f) was to eliminate a reporting burden, specifically the filing of a partnership income tax return in addition to the spouses' joint income tax return, while ensuring that both participating spouses, rather than just one spouse, may receive social security credit for their net earnings from self-employment. The purpose of section 761(f) was not to convert income that would otherwise be excluded from NESE altogether into income that is subject to self-employment tax.

As stated above, a sole proprietor with non-farm rental real estate income would not pay self-employment tax on such income unless it is received in the trade or business of a real estate dealer. Accordingly, in the case of a husband and wife who make the QJV election for a rental real estate business, each spouse has a share of the QJV income, and each spouse may exclude his or her respective share of the QJV income from NESE pursuant to the exclusion provided by section 1402(a)(1).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We understand that following the instruction to those making a QJV election to report rental real estate income from a QJV on Schedules C rather than Schedules E may prompt IRS inquiries when a taxpayer files a Form 1040 with Schedules C attached but no corresponding Schedules SE. We recommend that the appropriate Service Center functions be alerted to this issue so that the appropriate actions can be taken to ensure the self-employment tax provisions are applied correctly.

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Please call me or _____ of my office at _____ if you have any further questions.